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Municipal Debt Consolidation in Hungary (2011-2014) in an Asset Management Approach



Summary

The purpose of this study is to present Hungarian debt consolidation, its root causes and features in terms of local governments' asset management. As an additional aim, it intends to reveal the characteristics of the Hungarian municipal system, the causes that led to debt consolidation and the rule-based measures taken to prevent future indebtedness. The study focuses on the effects of debt consolidation on asset management in the Hungarian municipal system, and particularly on the operation of cities with county rights, as they have important regional duties. There are 23 of them with roughly 2 million inhabitants, thus in the aggregate they represent as many people as the capital city. This article reveals the reasons underlying the difficult financial situation of local governments, the solutions and subsequent impacts on municipal assets.

Journal of Economic Literature (JEL) code: H74, H71, H77, H72

Keywords: local government indebtedness, debt consolidation, local government debt, Hungary

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INTRODUCTION

Before 2011 the relevant literature classified the Hungarian municipal system in the transitional group among municipal system models. This means that between the change of regime and the entry into force of the Act CLXXXIX of 2011 on Local Governments of Hungary the statutes required a relatively small specific size of population to fulfil numerous tasks. Hence the local governments were charged with important tasks, as in addition to the operation of the municipalities the operating the human infrastructure was also on their shoulders. The revenue autonomy was given for that in the municipality segment, but only about 10 percent of the entire municipal system was able to utilize its own revenues appropriately. In this study we used the asset management approach to examine the municipal operation, the effects of debt consolidation, and the factors and contexts of the legislative environment influencing the asset management. In the study the municipal system was analysed, shifting the focus to the cities with county rights during the evaluations.

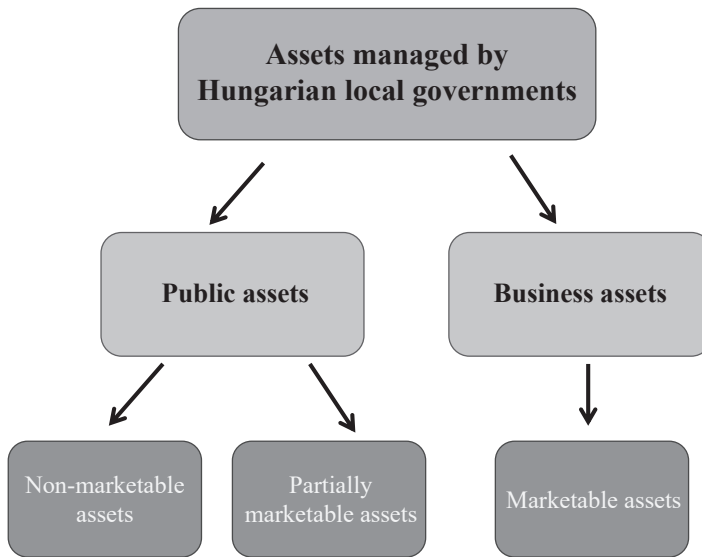
LITERATURE REVIEW

Municipal asset management

One of the fundamental conditions of municipal autonomy is the ownership of an appropriate amount of assets for the fulfilment of their tasks. Municipal assets can include real properties, moveable, fixed or intangible assets. As it is set by the Fundamental Law of Hungary, the properties of local (and state) governments are national assets (Lentner, 2013). Although local governments do not pursue profit in the course of their operation, it is still important to maintain their assets and to continuously improve the quality of the services they provide. It is part of the goals of local governments and the performance of their duties that they cannot produce a loss during their management of finances. The efficiency, economy and effectiveness of this management are preconditions of the municipal existence (Zéman and Tóth, 2015). Local governments generally engage in non-profit cost management, and in an attempt to classify them on the basis of typical management forms in the types described in the relevant literature, local governments would be found not to fit into any of the basic types due to their special activities (Zéman, 2017). “Public assets” have been defined by many authors in the literature. According to Hegedűs et al. (2007), they include every asset required for a functioning state or used for the performance of public duties. The management of public assets includes a set of decisions on the size, operation, development, enlargement or disposal of the state’s assets. Bencze (2006) divided public assets into capital and non-capital assets, the latter being the private property of the state. Based on Vigvári, asset management is the income-producing activity performed with assets other than intended for the fulfilment of core tasks. These activities are “the utilization of money and financial assets, using them in various rental relationships and in other forms, and in extreme cases the sale of properties (assets)” (Vigvári, 2007, p. 22).

During the management of public assets, the tasks that need to remain in state competence and the bodies in charge of them within the government budget must be specified. The literature devotes a great deal of attention to municipal asset management, and especially the management of real properties (Kaganova and McKellar, 2006; Vigvári, 2007).

Figure 1: The taxonomy of Hungarian municipality assets



Source: Act on Hungary's national assets

According to the Act CXCVI of 2011 on National Assets, public non-marketable capital assets are registered as being in a municipality's exclusive ownership or are classified by law as national assets of strategic significance for the national economy. National assets assigned to the exclusive ownership of local governments include: local roads and their structures; municipality-owned areas, domains and parks; municipality-owned international commercial airports and the related aeronautical telecommunication devices, radio navigation and lighting equipment, together with the establishments providing accommodation for the air traffic control service; and waters and public water facilities assigned to the local government pursuant to a special act, excluding water utilities (Lentner, 2013). According to a study by Bende-Szabó (2014), non-marketable asset are characterised by: inalienability, prohibition of limitations (with the exceptions of trustee rights and the right of use), prohibition on collateralisation and prohibition on inclusion in any property in undivided common ownership. Partially marketable assets are the municipality-owned utilities, buildings and holdings in companies involved in public services or car parking activities (Figure 1).

The causes and procedure of local governments' debt consolidation

Regarding their regulation, local governments have undergone significant evolution, but with respect to their characteristics the basic constellation has remained; they are in charge of the organisation of public services without being the effective service providers. The municipal sub-system paid dearly for the 2006 Convergence Programme, since local governments had to solve the financing of the key social services with a decreasing subsidisation on real terms, which also meant decreasing aids on nominal terms after 2009. The reserves of the system had been completely used up by 2006, and as a result of the promised regulation of lending, local governments increasingly indebted, although this indebtedness took the form of bonds of several atypical characteristics (Vigvári, 2009a; 2009b).

Although the volume of municipal debt was very small compared to the size of central government debt, on the basis of the investigations of the State Audit Office (SAO), in 2011 the municipal subsystem had to cope with a substantial level of financial uncertainty. Local governments had no backup to repay the loans taken and their bond debts. In 2011 the SAO spent most of its investigation capacity on local governments. SAO reports revealed that the financial balances of local governments deteriorated significantly between 2007 and 2010, and the absence of operational and accumulation resources appeared simultaneously in the system. The main problem derived from the fact that local governments had not made appropriate reserves for the repayment of their liabilities. The fact that the capital assets were also offered as collateral for loans and increasing trade payables also involved risks (Lentner, 2014). So after 2010, local governments' existence was at the brink of bankruptcy due to the acute operational deficits and the expired repayment moratoriums of investment loans and bonds. It was clearly illustrated by the State Audit Office in 2012 that the municipal sector's net operating income had turned negative, and this suggested extremely serious financing difficulties.¹ Vasvári (2013) identified the operational deficit as the reason for indebtedness, while the State Audit Office (2012) blamed the investment objectives planned in the given development cycle. However, we should remember the moral hazard posed by the banking system, as municipal bond issues were primarily financed by short-term instruments, and therefore it is safe to say that the Hungarian banking system did not take a responsible approach. Moreover, the bonds did not have a secondary market, thus in effect they were used to evade procurement rules. Although the relevant loan regulations limited debt service to 70 percent of the adjusted own revenues in the municipal sector, in practice they did not present an effective limitation and borrowing was not subject to authorisation either. Despite the State Audit Office's establishment of a breach of regulation, the law was not enforced.

As a result, signs of inoperability started to appear in the municipal sector, especially at the level of villages and county municipalities with insufficient revenues of their own. The economic policy-makers recognised the unsustainability of the situation and decided to consolidate the debt accumulated by local governments in four

steps between 2011 and 2014. A significant part of the assumed debt was denominated in foreign currency, and this resulted in a high exchange-rate risk, causing financial instability to both the local and the central sub-systems. The state, reorganised in 2010, had carried out a successful fiscal consolidation by 2013 (Lentner, 2015a; Lentner, 2015b, Lentner 2015c).

The consolidation of local government debt was performed in five steps. In 2011, the debt of county municipalities was assumed by the state in the value of HUF 197.6 billion. County governments competences had been limited to the maintenance of institutions, and they had no relevant revenues of their own, as half of all dues paid by the population had been paid to the central budget in 2009, and thus debt assumption was a logical move, followed by the take-over of the assets concerned.

This was followed by the assumption of debt accumulated by municipalities with less than 5000 inhabitants. The central government assumed the debts of 1710 municipalities in the value of HUF 74 billion, at a fixed rate in the case of EUR-based and CHF-based debts, and this debt was financially settled on 28 December 2012. Finally, during the consolidation of the debts of municipalities with than 5000 inhabitants, 1684 municipalities were relieved of their debts in the amount of nearly HUF 50.5 billion, denominated in local currency, and within this framework, HUF 73 million was paid to the Hungarian State Treasury as security deposits. 97 municipalities had debt denominated in CHF, and the central government budget assumed debt worth CHF 94 million contracted in 102 loan agreements. In addition, HUF 835 million owed as debt denominated in EUR under 16 loan contracts of 13 municipalities was also assumed (Lentner, 2014; 2015a; Gyirán, 2013).

In phase two, on the basis of Act CCIV of 2012 on the 2013 Central Budget of Hungary the central government assumed part of the debts (and all dues accrued on them) owed by local governments with over 5000 inhabitants and outstanding on 31 December 2012. The ratio of debt to be assumed was determined on the basis of the number of inhabitants in a particular municipality and the taxation power measured by the local business tax (based on the 2012 interim reports and the demographic data valid on 1 January of the same year), taking the adjusted mean value of the relevant municipality category into consideration. The Act CCIV of 2012 defined four municipality categories. The mean of each municipality category was calculated by the simple arithmetic average of the statistical population concerned, leaving the top and bottom 10-day-periods. Thus if the taxation power of a municipality was equal to or exceeded the adjusted mean value, 40 percent of the municipality's debt was assumed, and those with 75-100, 50-75 and less than 50 percent taxation power, 50, 60 and 70 percent of the debt was assumed, respectively. According to the 2012 interim reports, the average taxation power relating to the categories was HUF 13.3 thousand in villages with more than 5000 people, HUF 16 thousand in towns with inhabitants between 5000 and 10,000, HUF 23.5 thousand in towns with more than 10,000 inhabitants and HUF 36 thousand in the case of cities with county rights. This represented the debt of 305 municipalities in the value of HUF 685 billion, HUF 477.1 billion of which were in bonds ultimately redeemed under the Act CCIV of 2012. The agree-

ment between the central and the local governments for the extent of the assumptions was signed on 28 February 2013 (Lentner, 2014; 2015a; Gyirán, 2013).

Phase three was announced in the autumn of 2013, when the remaining debt of HUF 420 billion was assumed by the state, given that during the technical discussions 90 percent of the municipalities had applied for a greater debt assumption. On 28 February 2014, the government assumed the remaining HUF 420 billion debt as at 31 December 2013 (Lentner, 2014; 2015a; Gyirán, 2013).

MATERIALS AND METHOD

In the study the reasons behind the indebtedness of local governments and the difficulties encountered during their financial management were analysed. The procedure of debt consolidation was studied in the context of local governments through document evaluation and literature processing. We narrowed the focus of the analysis to cities with county rights and their debt consolidation, with the data taken from the Hungarian State Treasury.

The effects of debt consolidation were analysed first through the evaluation of the municipal assets, based on the data of the National Bank of Hungary, and the through the accounting indicators obtainable from the reports of the cities with county rights. The reports were made available by the Hungarian State Treasury, and contained the aggregated data of cities with county right between 2014 and 2016.

ACHIEVEMENTS

Debt consolidation in cities with county rights

Due to their size, cities with county rights were included in debt consolidation in the course of 2013 and 2014, after the Act CCIV of 2012 and Government Decree no. 1808/2013 (XI.12.) on the local governments' 2014 debt consolidation had entitled them to participate.

In the course of the previous consolidation performed in 2013, part of their debt was consolidated on the basis of their performance measured by their taxation power. In the first phase of the consolidation, the value of the debt assumed from cities with county rights was roughly HUF 237.9 billion, as the central government budget assumed an average of HUF 10.3 billion of debt from the 23 cities with a relatively high standard deviation of HUF 7.11 billion.

A significant amount of debt was assumed from Pécs, Miskolc and Debrecen. The lowest amount was assumed from Zalaegerszeg and Salgótarján. In 2014, in the second phase of debt consolidation a lower amount was assumed (HUF 134.85 billion), with an average value of HUF 5.8 billion and a standard deviation of HUF 3.7 billion. In comparison with the first phase, during the 2014 consolidation, an average of 64 percent of debt was assumed, with 30 percent standard deviation and a median of 55.3 percent, thus the data was slightly unevenly spread. This can be explained by the fact that in 2014 was con-

Table 1: The debt consolidation for Hungarian cities with county rights

| Municipality | Debt consolidation in 2013, th HUF | Debt consolidation in 2014, th HUF | Total debt consolidated | Consolidated per capita debt, th HUF |
|---------------------|---|---|--------------------------------|---|
| Békéscsaba | 6,002,031 | 3,920,774 | 9,922,804 | 160.0 |
| Debrecen | 18,072,173 | 10,103,459 | 28,175,633 | 137.5 |
| Dunaújváros | 10,843,491 | 5,695,756 | 16,539,247 | 339.7 |
| Eger | 4,831,453 | 3,401,550 | 8,233,003 | 151.1 |
| Érd | 8,093,088 | 3,364,343 | 11,457,430 | 175.0 |
| Győr | 3,392,210 | 4,455,919 | 7,848,129 | 62.1 |
| Hódmezővásárhely | 15,650,835 | 6,891,340 | 22,542,175 | 485.9 |
| Kaposvár | 13,987,452 | 5,706,299 | 19,693,751 | 297.9 |
| Kecskemét | 9,152,404 | 7,631,905 | 16,784,309 | 149.6 |
| Miskolc | 25,661,751 | 10,495,978 | 36,157,730 | 217.5 |
| Nagykanizsa | 4,127,728 | 2,210,802 | 6,338,530 | 128.2 |
| Nyíregyháza | 12,123,347 | 6,707,927 | 18,831,275 | 158.0 |
| Pécs | 29,227,423 | 16,519,422 | 45,746,846 | 300.1 |
| Salgótarján | 2,090,110 | 1,167,397 | 3,257,507 | 84.8 |
| Sopron | 11,455,657 | 4,103,752 | 15,559,409 | 265.5 |
| Szeged | 14,075,427 | 11,024,642 | 25,100,069 | 151.4 |
| Székesfehérvár | 9,452,942 | 4,752,523 | 14,205,465 | 141.9 |
| Szekszárd | 3,529,058 | 2,414,675 | 5,943,733 | 173.8 |
| Szolnok | 13,702,624 | 7,071,966 | 20,774,590 | 283.2 |
| Szombathely | 10 638 947 | 4,477,818 | 15,116,765 | 193.3 |
| Tatabánya | 5,375,663 | 8,996,451 | 14,372,113 | 203.6 |
| Veszprém | 4,987,253 | 2,487,933 | 7,475,186 | 129.2 |
| Zalaegerszeg | 1,448,931 | 1,243,940 | 2,692,871 | 45.6 |

Source: The authors' research based on data from the Hungarian State Treasury

siderably more debt was assumed than in 2013 in some of the municipalities. These cities included Tatabánya and Győr, while the data for Zalaegerszeg, Eger and Dunaújváros was close to the debt assumption made in 2013. A minor amount of the debt was assumed in the case of Zalaegerszeg, Salgótarján, Szekszárd, Veszprém and Nagykanizsa (Table 1).

The aggregate of the two years' data show that HUF 372.77 billion were assumed by the central government. Pécs had the largest amount of debt assumed, followed by Miskolc, Debrecen and Szeged. Among the cities with less than 100,000 inhabitants, Hódmezővásárhely had the highest amount of debt assumed.

The average amount of debt assumed relative to the population was HUF 193,000 per capita, while the standard deviation of the debt was HUF 99,000 per capita. The per capita debt assumed was significant in Hódmezővásárhely, Dunaújváros, Kaposvár, Pécs and Szolnok, and it was low in Zalaegerszeg, Salgótarján and Győr.

The effect of debt consolidation on the financial management of cities with county rights

The financial management of cities with county rights was analysed using accounting indicators. The data clearly show that after consolidation capital strength is high, but shows a declining trend. This is due to the fact that the use of funds from the European Union significantly increases the role of passive deferrals, as confirmed by the extremely low ratio of liabilities (2%).

Table 2: The effects of debt consolidation on the management of cities with county rights

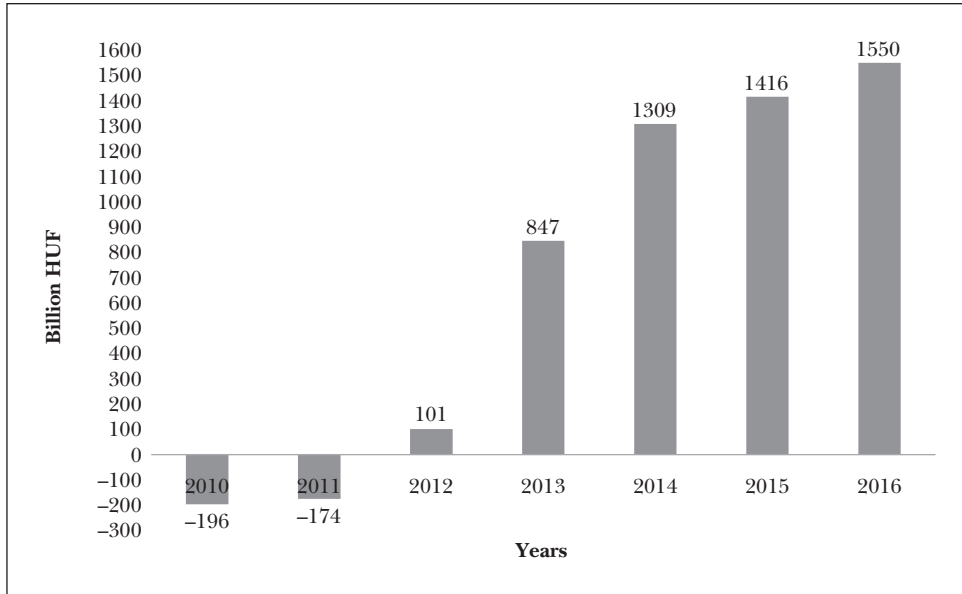
| Indicator | 2014 | 2015 | 2016 |
|---------------------------|-------------|-------------|-------------|
| Equity ratio | 94.6% | 92.7% | 86.0% |
| Leverage ratio | 2.2% | 1.9% | 2.3% |
| Ratio of fixed assets | 93.2% | 93.4% | 87.3% |
| Change in fixed assets | 100.0% | 104.8% | 105.5% |
| Coverage for fixed assets | 101.5% | 99.2% | 98.5% |
| Liquidity ratio | 5.2 | 14.7 | 27.3 |
| Acid test ratio | 5.2 | 14.6 | 27.2 |
| Cash and liquid assets | 2.8 | 7.3 | 20.8 |
| Ratio of own revenues | 45.5% | 45.8% | 38.9% |
| Equity growth | 5.2% | 1.2% | 0.3% |

Source: The authors' research based on data from the Hungarian State Treasury

The fixed asset ratio gives the ratio of long-term assets to the total assets held by local governments. The data reveals that by the final year the ratio of fixed assets had slightly dropped, however, in relation to 2014 a steady 5 percent increase is shown, implying that cities with county rights can expand their operating assets at an aggregated value (Table 2). The cash flow of municipalities may be considered as fairly good in the aggregate, or in other words, local governments have excellent solvency, several times the size of their short-term liabilities on the asset side. The ratio of their revenues and increase in equity (i.e. the efficiency of operation) are relatively high, and this enables stable operation. A slight decline is shown in the last year reviewed, but the continued 2014 and 2015 trend may be the measure of a prudent municipal operation.

An adequate indicator of local governments' financial position is the central bank's statistics about trends in net financial assets. Clearly, in 2010 and 2011, aggregated liabilities exceeded the financial assets of local governments, and this points to an unsustainable situation (Figure 2). In the course of debt consolidation, the financial assets of local governments started to grow significantly, and nearly doubled compared to 2013, representing a record increase in nominal terms, as they had never had such a high amount of funds without liabilities. Municipal liabilities primarily comprise trade payables and loan debts, amounting to HUF 300 billion and HUF 80 billion, respec-

Figure 2: Net financial assets of Hungarian municipalities



Source: National Bank of Hungary, 2017

tively, in 2016. Relieved of debts, local governments could basically make a fresh start in 2015. Local government functions have undergone the most profound change since the adoption of the current municipal structure 1990. This procedure may be termed as a kind of streamlining and it was implemented through the re-centralization of several tasks, representing a shift towards a healthier framework. In addition to streamlining functions, budgetary regulations are now applied in previously unregulated areas of operation: they are not allowed to plan deficit in their operating budgets or have renewable non-current operating loans, in order to create the conditions of cost-efficient management; authorization is required for borrowing, whether in the form of loans or securities issuance (primarily of bonds and bills of exchange). The aim of this regulation is to only allow municipalities to take out loans under regulated circumstances, with the approval of the Ministry for National Economy, and to guarantee the flexibility for their contribution to projects carried out using European Union funds and for low-value loans (HUF 10 million for towns, and HUF 100 million for cities with county rights and the capital). The local government sector runs a risk arising from the fact that in the course of the majority of the municipality projects no additional funds are generated to cover debt service, resulting in an operational cash-outflow in addition to the investment costs, which may deteriorate the operating income of local governments and the financial capacity that indicates long-term financial viability (net operational income). To avoid this, local governments are not allowed to undertake new investments if their debt service exceeds 50 percent of their income. This encourages local governments to implement projects that do not generate additional operating costs.

Since 2015 local governments have the option to access additional development resources through the system of municipal taxes levied on incomes not taxed by central and local taxation regulations. In other words local government independence has increased in terms of income. Based on the theories and scientific achievements of fiscal federalism, in particular the TOM (Tiebout, Oates and Musgrave) model, a reasonable solution is taxing bases that are immobile and only have a minor impact on the economy of the municipality. The competences of county governments and the capital city's government to perform regulatory review have been extended and added legislative powers.

Both the operating and the accumulation budgets of local governments have been restricted, but on the other hand, the opportunity is provided to establish autonomous and flexible financing. So the Hungarian regulation is now closer to the stricter practice of OECD countries, contrary to the previous, rather liberal regulation (Sutherland, 2005). However, municipal economy does not only include the establishment of local authorities and functional service organisations, but also the organisation of public duties. The Act CLXXXIX of 2011 requires local governments to perform 21 mandatory duties, most of them through companies in municipality ownership. The principal risks posed by municipal enterprises are that they can affect the municipality without being included in their balance sheets, thus creating an off-balance sheet risk (Schick, 1998; Polackova, 1999; Hegedűs and Papp, 2007; Hegedűs and Tönkő, 2007).²

Conditional liability means that the municipalities acting as owners are liable for their loss-making companies or for the debt services of their companies, even if the latter are not operated in compliance with the accounting principle of going concern. Unfortunately, a significant amount of debt has been accumulated by municipal companies, especially those of cities with county rights. Risk management actions included the following:

- 1) debts incurred by and the guarantees granted to municipal companies must be indicated in local government accounts from 2014;
- 2) debt generating transactions by companies in more than 51 percent local government ownership are subject to authorization just as the similar transactions of municipalities as owners;
- 3) the acquisition of municipal ownership in companies is now limited.

Pursuant to the regulations of the Treaty of Rome and the Treaty on the Functioning of the European Union, direct state aid is forbidden and therefore municipal companies must endeavour to manage their budget to match their revenues, in accordance with the findings of the State Audit Office (Németh et al., 2016). If necessary, the financial government can use the tool of consolidation, but the persistence of the soft budgetary threshold can only be avoided by laying down general rules (Lentner, 2013; 2015b; 2015c).

The SAO outlined a 4-point package of proposals for the renewal of state management, which contained the following:

- 1) the performance of the heads of state-owned and municipality-owned companies must be constantly assessed in terms of compliance, effectiveness, efficiency and economy;

2) the efficiency assessment and activity of the holder of the ownership rights must be improved;

3) the heads of state-owned and municipality-owned companies must comply with strict ethical and integrity principles; and

4) the remuneration of the heads of such companies must be changed (SAO, 2015a; 2015b; Domokos et al., 2016).

SUMMARY

The tasks, competences, financing structure and assets provide an appropriate basis for the financial management of municipalities. Based on the experiences, municipal debt consolidation was a novelty, since previously there had been a consensus that the central government should keep out of municipality debts. In our opinion this action was crucial because their indebtedness would have made the existence of numerous cities, towns and villages impossible. In this context, further actions were made in order to control or even prevent the build-up of future debts.

An assessment of the repercussions reveals that local government assets have been increasing and their management has improved since the consolidation, and this can serve as a basis for an ongoing stable operation.

NOTES

¹ In the case of a negative net operating income (operating income minus principal repayment), the local government will soon be caught in a debt trap.

² This phenomenon was detectable in Thailand prior to the turn of the millennium.

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